REPORT OF EXAMINATION BY THE SECURITIES BUREAU OF QUANTUM FINANCIAL ADVISORS, INC.

D.C. Official Code, Chapter 56, Title 31, Section 5602.02 – Licensing of Investment Adviser and Investment Adviser Representative

1. D.C. Official Code, Chapter 56, Title 31, Section 5602.02 of the DC Securities Act (the "Act") provides that a person shall neither transact business in the District of Columbia (the "District") as an investment adviser or an investment adviser representative nor be employed as an investment adviser representative unless the person is licensed or exempt from licensure under this chapter.

During the examination, the Examination Division (the "Division") of the Securities Bureau (the "Bureau") of the District's Department of Insurance, Securities and Banking (the "Department") learned that Quantum Financial Advisors, Inc. ("QFAI" or the "adviser") signed a referral agreement with Mr. Dana Barooshian (IARD # 4746763) on December 8, 2003. Sometime around November 2003, the adviser attempted to register Dana P. Barooshian as an investment adviser representative by having Mr. Barooshian take the Series 66 examination. However, Mr. Barooshian did not become licensed by the Department as an investment adviser representative. A review of the adviser's client files revealed that Mr. Barooshian brought a new account to QFAI on December 20, 2003. The adviser indicated that Mr. Barooshian was a solicitor. The adviser claimed that Mr. Barooshian has not received his solicitation fee, but the adviser will receive it after Mr. Barooshian is licensed as an investment adviser representative.

The adviser's payroll records showed that the adviser employs at least fifteen (15) other persons in the same manner, some with solicitor's agreements on file as indicated below. The Division's records indicated that the persons stated below are not registered in the District as investment adviser representatives. Also, the adviser's sole direct owner, Joseph F. Rinaldi III (IARD # 1012144), is not licensed as an investment adviser representative.

a. Dana Barooshian (IARD # 4746763);
b. Andrew Bernard Martin (IARD # 4484517);
c. Richard Stone (No IARD number);
d. Joel Schmeltz (No IARD number);
e. Martin Wilens (IARD # 466914);
f. Raymond Yin (No IARD number);
g. Michael Rilley (No IARD number);
h. Herbert Goldman (Solicitor's agreement on file) (No IARD number);
i. Marlene Patton (Solicitor's agreement on file) (No IARD number);
j. Business Solution Adviser (No IARD number);
k. Charlene Lawrence (No IARD number);

l. Richard Starr (No IARD number);

m. Force Financial System ("Force") (Solicitor's agreement on file) (IARD # 114401);

n. Eric Richfield Majors (Solicitor's agreement on file) (IARD # 2484297);

o. Wang Ying (No IARD number);

p. Li Chang Jun (No IARD number);

q. Carole Rose Flaume (No IARD number);

r. INFE.COM (Solicitor's agreement on file) (No IARD number);

s. Capital Funding Corp. (Solicitor's agreement on file) (No IARD number); and

t. Sophia C. Li (No IARD number).

D.C. Official Code, Chapter 56, Title 31, Sections 5603.01 and 5605.01 – Registration Requirement and Unlicensed or unregistered activity.

2. D.C. Official Code, Chapter 56, Title 31, Sections 5603.01 and 5605.01 (1) of the Act provides that a person shall not offer or sell a security except in accordance with the Act.

> During the examination, the Division learned that QFAI uses a website to communicate information to the public. On that website, www.qfainc.com, under the hyperlinks, "Ventures" and "Current Projects/ F.A. Roll Up", in a document entitled "Investor Summary"[1], the adviser offered stock in QFAI. The website states that "QFA requires approximately US$5,000,000 of equity financing in exchange for 25% of the company's capital stock". Under the same hyperlink, the adviser also offers securities in its "QFA REIT 2002-A", a real estate investment trust. The Division's records indicated that the offerings in QFAI and its REITs were not registered or notice-filed with the Department.

D.C. Official Code, Chapter 56, Title 31, Section 5605.02 – Fraudulent Transactions.

3. D.C. Official Code, Chapter 56, Title 31, Section 5605.02 (d) of the Act provides that in the solicitation of, or dealings with, advisory clients, a person shall not knowingly make an untrue statement of a material fact, or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading.

> During the examination, the Division learned that QFAI uses a website to promote and market advisory services to the public. On the website, the adviser claimed that "[d]uring the past three years [before September 2001, the date of the publication], QFA has enjoyed growth and profitability, with revenues increasing by 228%, 76% and 101% respectively, *[sic]* and net profits by 16%, 93% and 48% respectively." The records to justify the growth and profitability of QFAI were not available during the examination.

D.C. Official Code, Chapter 56, Title 31, Section 5605.04 – Misleading Filings.

4. D.C. Official Code, Chapter 56, Title 31, Section 5605.04 of the Act provides that a person shall not make, or cause to be made, in a document filed with the Commissioner or in any

[1] See the adviser's web page (see http://www.qfainc.com/pdf/Offering_Summary/English_S_9_2001.pdf).

proceeding under this chapter, a statement which is, at the time and in the light of the circumstances under which it is made, false or misleading in any material respect.

> QFAI made a filing with the Department on December 21, 2002 in which it stated that "it does not have custody of clients' funds". Under Item 2. I(1) of Form ADV, Part 1B, the adviser stated that it does withdraw advisory fees directly from clients' account. The adviser also stated that (1) it sends a copy of its invoice to the custodian at the same time that it sends a copy to the client; and (2) it sends quarterly statements to clients showing all disbursements for the custodian account, including the amount of the advisory fees. During the examination, the Division learned that QFAI did not establish, maintain and preserve records indicating that it does not have custody. The adviser could not produce records showing that it sends a copy of its invoice to the custodian at the same time that it sends a copy to the client; and that it sends quarterly statements to clients showing all disbursements for the custodian account, including the amount of the advisory fees.

Rule 1876 – Unlawful, unethical or dishonest conduct or practices

5. Rule 1876.1 (a) states that it is deemed to be unlawful, unethical, or dishonest conduct or practice by an investment adviser who recommends to a client to whom investment supervisory, management or consulting services are provided the purchase, sale or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and nay other information known by the investment adviser.

> During the examination, the adviser stated that he uses an Estate Planning Questionnaire with each client to assess client suitability before recommending any investment program. However, he indicated that he destroys the questionnaire once the account is opened. The adviser was unable to produce documents to the examiners to evaluate the suitability of investment programs to clients.

6. Rule 1876.1 (b) states it is deemed to be unlawful, unethical, or dishonest conduct or practice by an investment adviser who exercises any discretionary power by placing an order for purchase or sale of securities for a client without obtaining written discretionary authority from the client within ten (10) business days after the date of the first transaction placed pursuant to oral discretionary authority.

> A review of the adviser's records revealed that the adviser has discretionary authority over assets under management of $15,000,000.00; however, the adviser was unable to provide any copies of any power of attorney. The clients' contracts also reflected no written authorization of discretionary authority.

7. Rule 1876.1(d) provides that an investment adviser is a fiduciary, and prohibits unethical business practices, such as placing an order to purchase or sell a security for the account of a client without authority to do so.

> The adviser was unable to provide any documents to support his authority to exercise discretion over clients' accounts.

8. Rule 1876.1 (h) states it is deemed unlawful to omit to state a material fact necessary to make the statements made regarding qualifications, in light of the circumstances under which the statements were made, not misleading.

During the examination and after a review of the adviser's records, the adviser makes several assertions in its disclosure documents and items found on its website:

- QFAI was registered in April of 1996 with its headquarter located in the District of Columbia and affiliates located in New York, New York and Las Vegas, Nevada.
- QFAI has an investment committee.
- The adviser charges an organizational and management cost annually to clients, but that cost is not disclosed on the Form ADV, Part II.
- QFAI's various disclosure documents contained inconsistent or directly contradictory statements of the years of experience of the firm.

The adviser was unable to provide any documents to support any of its assertions stated above.

9. Rule 1876.1(j) provides that an investment adviser is a fiduciary, and prohibits charging a client an unreasonable advisory fee.

During the examination, a review of client files disclosed that a client was charged a fee four percent (4%) based on the assets under management. The adviser's disclosure documents indicates that it will charge two percent (2%) "of the principle *[sic]* balance in the client's account" or assets under management. The higher fee is excessive in relation to charged to other clients for similar services. The disclosure documents neither revealed that a client could be charged as high as four percent nor describe the adviser's service for such an excessive fee.

10. Rule 1876.1(j) provides that an investment adviser is a fiduciary, and prohibits charging a client an unreasonable advisory fee.

During the examination and under QFAI's disclosure brochure, the adviser indicated that it charges a one percent (1%) fee charge for early termination. The disclosure documents did not describe the basis for such an excessive fee.

11. Rule 1876.1 (m) provides that an investment adviser is a fiduciary, and prohibits publishing, circulating or distributing any advertisement, which does not comply with Rule 206(4)-1 under the Investment Advisers Act of 1940 (17 CFR § 275.206(4)-1), or which contains any untrue statement of a material fact, or which is otherwise false of misleading.

The adviser uses several documents as part of his disclosures in addition to its Form ADV. The examination revealed that those documents are misleading. A review of QFAI's website revealed that the following information found may be misleading or untrue:

- The examination revealed that the adviser had moved out of its place of business sometime around November 2003 and set up an office in Maryland around the same time. The adviser's contact information on the website is not correct, because the adviser moved out of the District of Columbia. At the time of the examination, there were no records in the Division's file on IARD pertaining to the adviser's registration in Maryland; however, the adviser claimed that it had an office in Rockville, Maryland. The background of the company indicates that QFAI has affiliation in New York City and Las Vegas. QFAI failed to disclose this information on its Form ADV;

- QFAI is offering securities in its company without disclosing the fact that the stock is not registered or exemption from registration;
- The adviser indicated that QFAI is a registered "International Adviser". At the time that the information was provided to the public and reviewed for the examination, QFAI was registered only in the District of Columbia;
- On the adviser's website, under "Venture and Recent Projects", the adviser indicated that it completed projects and it is involved in current projects. The statement gives clients the appearance that the adviser has a successful business. The examination discovered that there were no records indicating the completion or continuation of the adviser's projects;
- The adviser's third quarter broadcast specifically indicates that clients' assets increased over 25% annually; and
- The adviser's third quarter broadcast indicates that the adviser will waive "adviser fees for amounts over minimum balance per household" for Multi-Manager 529 Plans. This statement and the service were not disclosed on the adviser's Form ADV. The adviser did not provide records for this service.

12. Rule 1876.1 (m) provides that an investment adviser is a fiduciary, and prohibits publishing, circulating or distributing any advertisement, which does not comply with Rule 206(4)-1 under the Investment Advisers Act of 1940, or which contains any untrue statement of a material fact, or which is otherwise false of misleading.

The adviser publishes its performance data on its website under the hyperlink "NEWS". An example of the adviser's advertisement is a document entitled "Broadcast 3rd Quarter 2003/October 10, 2003". In the document, the adviser claimed that "[o]n a performance basis, clients assets *[sic]* have increased over 13.5% on an annual basis, with only a 50% equity weighting." The performance data could not be verified by the adviser. The adviser was not able to provide all material facts on how this calculation was true.

13. Rule 1876.1 (p) provides that an investment adviser is a fiduciary, and prohibit entering into, extending or renewing any investment advisory contract unless such contract is in writing and discloses, in substance, that

1) no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract; and

2) whether the contracts grants discretionary power to the adviser.

A review of QFAI's contracts showed that the contracts failed to contain the "no assignment" provision and to state whether the contracts grants discretionary power to the adviser as required by this rule.

14. Rule 1876.1 (p) provides that an investment adviser is a fiduciary, and prohibit entering into, extending or renewing any investment advisory contract unless such contract is in writing and discloses, in substance, the amount of prepaid fee to be returned in the event of contract termination or non-performance.

A review of QFAI's contracts revealed that the contracts provides for a termination fee beginning at one percent (1%) and negotiable upwards. The adviser calls the fee a "back-end performance" fee. The adviser disclosed that it incurs set up costs, but does not explain or disclose, in substance, the costs incurred. Regardless of the costs incurred or its description, the adviser may be violating its fiduciary duty by not returning prepaid fees in the event of contract termination.

15. Rule 1876.1 (q) provides that an investment adviser is a fiduciary. The rule prohibits unethical business practices by the investment adviser, specifically including failing to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information contrary to the provisions of Section 204A of the Investment Advisers Act of 1940.

The adviser was unable to demonstrate that he has established written policies and procedures to prevent the misuse of material nonpublic information.

Rule 1875 – Custody Rule

16. D.C. Official Code, Chapter 56, Title 31, Section 5605.02 (g) of the Act provides that it is unlawful for an investment adviser to have or take custody of client assets unless the adviser notifies the Commissioner in writing that it has or may have such custody and the adviser complies with the provisions of Rule 1875.

During its examination, the Division learned that the adviser is paid automatically from client funds. The adviser could not produce records indicating that (1) the client provided written authorization permitting the adviser's fees to be paid directly from the client's account held by an independent custodian; and (2) the adviser sent to the client and the custodian at the same time, a bill showing the amount of the fee, the value of the client's assets on which the fee was based, and the specific manner in which the adviser's fee was calculated. The adviser had copies that the custodian sent to the client a statement, at least quarterly, indicating all amounts disbursed from the account including the amount of advisory fees paid directly to the adviser.

Rule 1852 – Investment Adviser Licensing and Renewal

17. Rule 1852.8 provides that no investment adviser representative may be registered with more than one (1) investment adviser unless the investment adviser, which employs or associates with the investment adviser representatives, is under common ownership or control.

The examination revealed that Force acts as a solicitor for the adviser. While Force is licensed as a registered investment adviser in Colorado, it is neither licensed in the District nor controlled or under common ownership with QFAI.

Rule 1853 - Duty To Amend Information Previously Filed

18. Rule 1853 requires an adviser to file timely amendments to its filings with the Department when the information contained in the Form ADV becomes inaccurate or incomplete in any material respect for any reason.

The adviser's Form ADV on file with the Department has not been amended to address the following changes or inaccuracies:

a. Item 1.F (1) of Form ADV, Part 1.A, reflected inaccurate place of business address of QFAI;
b. Items 1.F (3) and (4) of Form ADV, Part 1A, did not reflect the correct telephone number and facsimile of the QFAI;
c. Item 1.J of Form ADV, Part 1A, reflected inaccurate contact numbers and address of the contact employee;
d. Item 5.A of Form ADV, Part 1A inadequately disclosed the number of employees. During the examination, the adviser stated that he has eight (8) employees (one (1) with W-2 and seven (7) with 1099);
e. Item 5.E of Form ADV, Part 1A did not reflect consultation fees ranging from $500-$1,000 as stated by the adviser during the examination;
f. Item 5.F of Form ADV, Part 1A reflected inaccurate assets under management. During the examination the adviser stated that he has $15,000,000 in discretionary accounts and $10,000,000 non-discretionary accounts;
g. Item 11.D (2) of the Form ADV, Part 1A did not reflect that the Department has found the adviser to have been involved in a violation of investment-related regulations or statutes. Please answered this item in the affirmative;
h. Item 2.A of Form ADV, Part 1B reflected inaccurate address, telephone number and facsimile;
i. Item 1.D of Form ADV, Part II inaccurately reflected the adviser fee disclosure with its practice as revealed during the examination. While Item 1.D disclosed that fees are based on the "principle balance", the adviser did not disclose that the fee is based on the market value of the client's account;
j. Items 8.C (7) and (9) of Form ADV, Part II indicated that the adviser has a cross referrals relationship with Joe Schmeltz of "Pro-finance Accounting", a firm, and Richard Stone of "Life Time Benefits Insurance", a firm. The adviser failed to described the relationship and the arrangements;
k. Item 10 of Form ADV, Part II indicated that the adviser does have conditions for managing accounts, but failed to describe those conditions on Schedule F;
l. Item 12 .B of Form ADV, Part II indicated that the adviser does not suggest brokers to clients. During the examination, a review of the clients' files revealed that the adviser does suggest brokers to clients. This item should be answered in the affirmative;
m. Item 13.B of Form ADV, Part II indicated that the adviser does not have any arrangements where it directly or indirectly compensates any person for clients referrals. During the examination, a review of the clients' files revealed that the

adviser does compensate unregistered and unlicensed solicitors for client referrals. This item should be answered in the affirmative;

n. Schedule F for Item 1.D of Form ADV, Part II reflects hourly fee of $50-$400; during the examination, the adviser stated that the current hourly fees is $200-400;
o. The additional disclosure document received from the adviser stated an Organizational and Management costs to be paid annually. This information is not disclosed in the form ADV;
p. In other documents, the adviser indicated that the clients' accounts hold mutual funds, but he does not disclose that the clients are subject to operating expenses in addition to the advisory fees. This information should be disclosed on Schedule F of Form ADV; and
q. The examination revealed that on April 17, 2002, the adviser re-priced his fees for several of his clients through a mass mailing without an explanation and offered an "O's game" tickets for some clients, but not for all. There was no disclosure in the Form ADV to reflect any incentive offers to clients, such as seats to sports events.

Rule 1873 — Performance Based Compensation

19. Rule 1873.2 provides that contracts with clients that contain a performance-based fee provision must meet certain conditions set under this Rule.

During the examination, the adviser had several clients sign performance-based compensation agreement. The adviser was unable to provide any document showing that the clients met any conditions under this rule.

Rule 1854 – Solicitors

20. Rule 1854.1 provides that it shall be unlawful for any investment adviser or investment adviser representative licensed or required to be licensed under the Act to compensate, directly or indirectly, any person who acts as a solicitor, unless such person is licensed as an investment adviser representative.

The examination revealed that the adviser has had a referral relationship with seventeen (17) persons (see persons listed under number 1 of this letter). At the time of the examination, a review of the Division's records reveal that these persons are not licensed as investment adviser representatives who solicit clients for the adviser. The nature of the referral relationship indicated that the persons solicit for the adviser.

Rule 1868 - Supervision

21. Rule 1868.3 requires that an investment adviser must establish, maintain and enforce written procedures to supervise its investment advisory activities.

The adviser was unable to produce written supervisory procedures.

22. Rule 1868.1 provides that an investment adviser shall exercise diligent supervision over the investment advisory activities of its investment adviser representatives and employees.

The adviser was unable to produce any documentation showing that it had exercised diligent supervision over the investment advisory activities of its investment adviser representatives and employees.

Rule 1881 – Investment Adviser Recordkeeping.

23. Rule 1881 provides that an investment adviser must maintain and preserve certain books and records.

The adviser was unable to produce the following books and records:

a. Cash receipts and disbursements records;

b. Memorandum of each order by the adviser for the purchase or sale of any security or assets, of any instruction received by the adviser from the client concerning the purchase, sale, receipt, or delivery of a particular security or assets, and any modification or cancellation of any order or instructions;

c. Check books, bank statements, cancelled checks, and cash reconciliation of the investment adviser;

d. Bills or statements, or copies thereof, paid or unpaid, relating to the business of the investment adviser as such;

e. Originals of all written communications received, and copies of all written communication sent out, by the investment adviser relating to recommendation made or proposed to be made and advice given or proposed to be given, any receipt, disbursement or delivery of funds, securities or assets, or the placing or execution of any order to purchase or sell any securities or asset;

f. A list or other record of all accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities, assets, or transactions of any client; and

g. All powers of attorney and other evidence of the granting of any discretionary authority by any client to the investment adviser, or copies thereof.

The adviser was unable to provide any of the records listed above.

24. Rule 1881.4 provides that an investment adviser must maintain and preserve a copy of each written statement, and each amendment or revision thereof, given or sent to any client or prospective client of the investment adviser and a record of the dates that each written statement, and amendment, or revision thereof, was given, or offered to be given, to any client or prospective client who subsequently became a client in accordance with the provisions of section 1872.

The adviser failed to maintain a record of the dates the written disclosure statement was offered or given annually to any clients. The adviser was unable to produce any document in regard to advertisement in churches and schools.

25. Rule 1881.5 provides that an adviser will keep all accounts, books, internal working papers and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities.

During the examination and after receipt of further information from the adviser, the adviser was unable to produce internal working papers and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of three client accounts.

26. Rule 1881.7 provides that an investment adviser must make and keep a true, accurate, and current records showing separately for each client the securities or assets purchased and sold, and the date, amount, and price of each purchase and sale.

The adviser was unable to produce any records.

27. Rule 1881.7 provides that an investment adviser must make and keep, for each security or asset in which any client has current position, true, accurate, and current information from which the adviser can promptly furnish the name of each client, and the current amount or interest of each client.

The adviser was unable to produce any records.